October 21, 2002

Report

to

North Carolina Utilities Commission
South Carolina Public Service Commission

Prepared by
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Boston, Massachusetts

I. Introduction

Grant Thornton LLP was engaged by the North Carolina Utilities Commission (NCUC) and the South Carolina Public Service Commission (SCPSC) (hereinafter collectively, the "State Commissions") to provide certain services, the scope of which is fully set out in the Service Contract entered into on December 10, 2001 between Grant Thornton LLP and the State Commissions.

II. Background of Investigation

In July of 2001, Duke Power (Duke) received a "whistleblower" call to its ethics/compliance hotline, alleging that certain accounting irregularities had taken place at Duke Power during the closing of the year-end 1998 books. Duke reported the hotline complaint to both the SCPSC and the NCUC. In response to this call to its internal hotline, Duke engaged an Atlanta law firm to conduct a "compliance investigation", the results of which Duke has refused to disclose as attorney-client privileged.

The whistleblower also made independent contact with the staffs of both State Commissions. The State Commissions requested that Duke provide pertinent documents and respond to written questions relative to the alleged irregularities. In response to the State Commissions, Duke conducted another investigation, primarily focused on fourteen 1998 year-end accounting entries. Duke reported the results of that investigation to both State Commissions in a 20-page letter (the "Duke Report") dated August 28, 2001. The State Commissions reviewed the Duke Report, as well as the materials provided by Duke, and decided to seek an independent evaluation from an outside accounting firm of both the allegations and Duke's responses to them. The "whistleblower" initiated the inquiry into Duke's alleged accounting irregularities, however Grant Thornton LLP (Grant Thornton) performed its own investigation of Duke's accounting methods and policies and arrived at its own conclusions independent of the "whistleblower".

A. Requests for Proposals and scope of Grant Thornton investigation

In October 2001, the NCUC and the SCPSC publicized Requests for Proposals ("RFP") seeking an independent evaluation of the fourteen year-end accounting entries that the whistleblower alleged were inappropriate. Grant Thornton submitted a proposal, incorporating services to be supplied by the law firm of Thompson Coburn LLC. After consideration of this and other proposals received in response to the RFP, the State Commissions entered into a Service Contract with Grant Thornton, with specific instructions that the inquiry "center around a thorough analysis" of the Duke Report.

The Service Contract instructed Grant Thornton to "send a cross-functional team of investigators to evaluate the accuracy of the representations/facts that appear in the Duke Report, addressing each of the fourteen accounting issues discussed therein." The Service Contract also specified, among other matters, that the investigators would (1) obtain an understanding of how the fourteen entries arose; (2) gain an understanding of Duke's accounting procedures and controls; (3) investigate changes and departures from normal procedures; (4) evaluate the factual background surrounding entries; (5) investigate and evaluate the manner in which Duke has classified expenses and costs between its utility and non-utility accounts and operations; (6) examine under oath appropriate Duke personnel to determine, among other factors, whether accounting procedures have been subject to change and what led to the fourteen entries in the Duke Report; and (7) evaluate the accounting treatment afforded the items in the Duke Report.

B. Nature of Grant Thornton inquiry

Grant Thornton accountants and lawyers from Thompson Coburn LLP initiated the investigation with a December 10, 2001 meeting with the staffs of both Commissions. Part of the initial meeting was also attended by Duke Power employees and attorneys. A request for documents was sent to Duke following this meeting and, at Duke's request, a confidentiality agreement was entered into by Grant Thornton and Thompson Coburn.

Investigatory fieldwork began in Charlotte in January 2002 and concluded in July 2002. Grant Thornton committed a number of accountants to the task, including a senior partner with extensive regulatory accounting expertise. Thompson Coburn committed two lawyers, including a former United States Attorney with extensive experience in investigations. In total, nearly 13,000 records (in both paper and electronic form) were reviewed. Included were emails and internal (Duke) memoranda. A total of 30 sworn depositions were taken from Duke employees and others.

C. Factors considered in conducting the investigation and in preparing this report

In accordance with the Service Contract, Grant Thornton's inquiry primarily has focused on two areas: Duke's conduct in 1998, 1999 and 2000 and the adequacy and accuracy of the Duke Report. Within that context, the investigation has included an evaluation of whether Duke complied with the Federal Energy Regulatory Commission's Uniform System of Accounts (the "USOA") and Generally Accepted Accounting Principles (GAAP) applicable to regulated utilities. The investigation has also looked to a number of other internal and external sources in evaluating Duke's accounting practices. The investigation has included an evaluation of certain Duke accounting practices in prior years and inconsistencies between those practices and the manner in which various accounting events/transactions were treated for 1998, 1999 and 2000. During the deposition process investigators weighed the credibility of witness testimony based on the demeanor and believability of the witness on key issues, the consistency of the witness' testimony with documents and the testimony of others, and the witness' ability to recall key events and discussions.

III. Overview of Findings

On Tuesday, December 8, 1998, the South Carolina Public Service Commission reduced the rates which South Carolina Electric and Gas (SCANA) was allowed to charge its customers after SCANA reported earnings over its allowed rate of return for the twelve month period ending September 30, 1998. Grant Thornton's investigation has found that, in reaction to the December 1998 SCANA decision, a number of Duke mid to senior level managers met and developed a plan to identify expense and revenue items which could serve as a basis for accounting adjustments which could be made to “avoid reporting over-earnings to regulators” (See Exhibit A attached). A focus of the plan was the identification and formulation of year-end 1998 entries which would minimize Duke’s earned return as reported to the State Commissions, but would not impact or lower Duke Energy’s consolidated earnings as reported to its investors or the Securities and Exchange Commission.

Grant Thornton has identified a number of entries made by Duke in the course of Duke’s dealing with its “allowed return problem”, as it was characterized by some Duke managers. The entries identified included some of the fourteen entries pointed out by the whistleblower and addressed in the Duke Report, as well as other 1998 year-end entries, and some that affected the utility operating results for 1999 and 2000.

Grant Thornton has identified entries, pre-income taxes (except for the RAR Tax Entry), totaling more than $64 million that inappropriately reduced Duke’s 1998 pre-tax utility operating income as reported to the State Commissions. In addition, Grant Thornton noted entries, pre-income taxes, that inappropriately reduced Duke’s reported pre-tax earned return by $23,958,348 for fiscal 1999 and $35,198,605 for fiscal 2000. A recap by year and area is as follows:

	A	B	C
FY 1998			
Description	Entry Amount	Amount GT Determined to be Inappropriate	Amount Duke Determined to be Inappropriate
1 - Nuclear Insurance	$ 26,491,308	$ 26,491,308	$ 4,000,000
2 - Deferred Executive Compensation	15,928,251	5,482,885	4,800,000
3 – Price Anderson Act	1,750,000	1,750,000	1,750,000
4 – Merchandising	6,038,146	6,038,146	5,100,000
5 - Information Management Costs	-	-	-
6 - Injuries and Damages - General Liability	7,000,000	-	-
7 - Injuries and Damages – Asbestosis	25,000,000	-	-
8 – DE&S Facility Costs	1,141,067	-	-
9 - Hydro Study Write-off Costs	1,238,267	1,238,267	1,238,267
10 - United Telephone Write-off	1,945,971	-	-
11 - December Ice Storm	2,620,305	-	-
12 - Sales and Use Tax Adjustment	1,706,063	621,000	-
13 - Oxford Fire	(772,228)	-	-
14 - Payroll Accrual	4,100,000	2,300,000	-
15 - RAR Tax Entry	17,745,703	17,745,703	-
16 - Incentive Accruals	2,744,000	2,744,000	-
	$ 114,676,853	$ 64,411,309	$ 16,888,267

FY 1999	A	B	C
Description	Entry Amount	Amount GT Determined to be Inappropriate	Amount Duke Determined to be Inappropriate
1 – Nuclear Insurance	$ 23,341,894	$ 23,341,894	-
2 – Deferred Executive Compensation	616,454	616,454	-
	$ 23,958,348	$ 23,958,348	-

FY 2000	A	B	C
Description	Entry Amount	Amount GT Determined to be Inappropriate	Amount Duke Determined to be Inappropriate
1 – Nuclear Insurance	$ 34,592,501	$ 34,592,501	-
2 – Deferred Executive Compensation	606,104	606,104	-
	$ 35,198,605	$ 35,198,605	-

A. Journal entry, recorded by Duke
B. Amount in Column A that Grant Thornton found was inappropriate
C. Per Duke's August 28, 2001 Report

In Grant Thornton's opinion, the entries identified and investigated for 1998, 1999 and 2000 can be classified as follows:

- **Reclassifications or Adjustments Which Were Completely Without Accounting Justification Under Any Accepted Accounting Standards**

  Some 1998 year-end entries recorded by Duke were completely without accounting justification under any accepted accounting standards. In Grant Thornton's opinion, evidence collected about these entries suggests that Duke managed the results reported to the State Commissions in order to enhance Duke's "allowed return" position. Two of the 1998 year-end entries recorded by Duke were without accounting justification. This classification of entries includes those concerning:

  - Price Anderson Act
  - Income Tax Entries (RAR)

- **Reclassifications or Adjustments which were made in part Inappropriately and Without Justification Under Any Accepted Accounting Standards**

  Grant Thornton believes that two of the investigated entries, based on information supplied by Duke, were in part made inappropriately and without justification under any accepted accounting standards. This classification of entries includes those categorized as:

- Merchandising
- Deferred Executive Compensation

- **Reclassifications or Adjustments Which Were Made Under Aggressive Interpretations of the USOA that Were Contrary to Applicable Accounting Principles, Industry Practice and Duke's Past Practice.**

  Grant Thornton believes that one of the investigated entries, based on information supplied by Duke, was made under an aggressive interpretation of the USOA that was contrary to applicable accounting practices, industry practice and Duke's past practice.

  This classification of entries includes:

  - Nuclear Insurance Refund Entries

- **Duke Took Advantage of Accounting Errors With The Purpose of Enhancing its Earned Return Position.**

  Grant Thornton believes that some of the investigated entries, based on information supplied by Duke, were made to take advantage of accounting errors with the purpose of enhancing Duke's earned return position. This classification of entries include those categorized as:

  - Hydro Study Write-Off Costs
  - Incentive Accruals
  - Sales and Use Tax Adjustment
  - Payroll Accrual

- **Accounting Entries Appropriate Under Applicable Accounting Principles**

  Grant Thornton believes that some of the investigated entries, based on information supplied by Duke, were appropriate, given applicable accounting principles. This classification of entries includes those categorized as:

  - Information Management Costs
  - Injuries and Damages – General Liability
  - Injuries and Damages – Asbestosis
  - DE&S Facility Costs
  - United Telephone Write-Off
  - December Ice Storm
  - Oxford Fire

  To the extent that the entries discussed in the first four classifications above (inappropriate entries) represented changes in Duke's accounting practices from prior years for recording/reporting similar or identical transactions, none of the changes in Duke's accounting practices were reported to the Federal Energy Regulatory Commission (FERC) at the time that they were made and the State Commissions were also not informed of the changes.

During Grant Thornton's investigation, Duke's posture to investigators was patient and cooperative, and every person requested for a deposition was made available. Investigators, however, had frequent problems with incomplete production, incomplete copying of what turned out to be critical documents or last minute and untimely production of critical memoranda. Several witnesses produced desk files on the eve of their depositions; some of these documents were critical to the inquiry and produced weeks after they could have been used in the depositions of other witnesses. The investigators found that the reasons given for last minute production were sometimes not credible (e.g., "I didn't know I was supposed to produce electronic files" was the reason given by one central witness for not producing a significantly relevant document until the night before his deposition.)

Investigators also encountered a serious problem in that a number of records were reported as no longer in existence. Although many witnesses reported that Duke had a document retention policy, no one questioned by investigators —including Duke Power CEO William A. Coley ("Bill") --knew what the policy was, to whom it was disseminated, or what documents it covered.

The demeanor of witnesses in sworn depositions ranged from candid and cooperative to what appeared to investigators to be deliberate evasiveness. Many witnesses professed to have no memory of accounting transactions that most described as "unique" or "unusual." One key witness (whom investigators identified as being at the center of the plan to reclassify or recharacterize income) stated under oath that representations he had made in an electronic memo were "not true" when he made them. (See Exhibit B attached) The statement confirms the existence of Duke's plan to deal with what it perceived to be an "allowed return problem" through a number of accounting reclassifications or adjustments.

IV. "Allowed Return Problem" as a Backdrop to Accounting Reclassifications

1. The Fall of 1998, prior to the SCANA Decision

A number of the people who were deposed by the investigators, including but not limited to William Stimart, Duke's former Regulatory Affairs Vice President (and in December 1998 a Duke consultant), Rick Ealey, Assistant Controller of Duke Power and Sandra Meyer, Duke's Vice President of Planning and Finance, all said that Duke personnel were giving consideration in the Fall of 1998 to the classification of losses and expenses related to the discontinuation of Duke's retail merchandising operations. The question being discussed involved whether such expenses should be accounted for "above the line," as a charge against the utility's operating income, or "below the line." Documents produced by Duke in connection with this matter indicate that some personnel at Duke characterized "above the line" expenses as those which Duke's electric customers paid, i.e., they were accounted for/and included in the electric rates paid by customers, while "below the line" expenses were characterized as "paid" by Duke's shareholders.

Ealey and Stimart testified that during the same period in the Fall of 1998, prior to the SCANA decision, consideration was also being given to the possible reclassification of nuclear insurance refunds from above to below the line. Meyer and Sarah Heidelburg, Duke Energy's Director of Corporate Accounting, testified that there was also some discussion during this period relative to the appropriateness of a reclassification of a portion of Duke's deferred executive compensation to above the line. Records were produced which reflect discussions, prior to the SCANA decision, of the retail merchandising adjustment; no records were produced which corroborate that any discussion of the nuclear insurance or the deferred executive compensation reclassification took place prior to the SCANA decision.

2. The SCANA Decision

On Monday, December 7, 1998, Steven Young, Duke's Vice President for Rates and Regulatory Affairs, met with Duke Power CEO Bill Coley at Coley's weekly staff meeting. At the meeting, Young reported discussions he had had during the previous week with SCPSC staff. According to Young, the SCPSC staff had expressed concerns about "…what is a reasonable allowed return…" for electric utilities. On Tuesday, December 8, 1998, the SCPSC reduced the rates which South Carolina Electric & Gas (SCANA) was allowed to charge its customers, without holding a hearing, after SCANA reported earning over its allowed rate of return for the twelve month period ending September 30, 1998.

3. Reaction to the SCANA Decision

William Stimart, Duke's former Vice President for Regulatory Affairs, was "shocked" by the SCANA decision, the effect of which he described as "devastating." Steven Young said that the SCANA decision was "big news" in the industry. Meyer said that Young reported on the SCANA decision at a staff meeting attended by CEO Bill Coley and others. Meyer also said that there was discussion at that staff meeting that there was a "risk to the Company" if Duke were to exceed its allowed rate of return.

4. Aftermath of December 8, 1998 SCANA decision and meetings and action taken before December 17, 1998

Subsequent to the SCANA decision but prior to December 17, 1998, Steven Young met with subordinate Don Stratton, Duke's Manager of Rates and Regulatory Affairs, about the SCANA decision. Duke Energy Controller, Jeff Boyer, also met with Stratton to discuss the SCANA decision.

Stratton prepared a three-page spreadsheet entitled "Analysis of EBIT," which calculated that Duke needed "$70 million [in] additional expense items…to avoid over-earnings to regulators" (See Exhibit A attached). The document identified a number of "additional expense provisions" for "reporting regulatory earnings" that included a number of the reclassifications or adjustments addressed by Grant Thornton.

Sandra Meyer met with Stratton, at Stratton's request. Meyer testified that Stratton "…just wanted to make sure I was aware of the importance of our filing given the SCANA decision." Stratton asked Meyer to direct Ealey to work with him to "review the records to ensure there wasn't anything reported incorrectly" from a regulatory reporting perspective. Meyer met with Ealey and asked him to review income and expense classifications, including nuclear insurance. Ealey met with Stratton and Kris C. Duffy, Manager of Reporting in the Planning and Finance Department, in Ealey's office. The three discussed expense items which could be considered for movement from "below the line" to "above the line."

5. December 17, 1998 meeting at Rick Ealey's office

On December 17, 1998, a meeting was held at the office of Rick Ealey, Duke Power's Assistant Controller, attended by Phillip Dean Helton, Manager of General Accounting, Kris C. Duffy, Christine Stachowicz, an entry level accountant who reported to Kris Duffy and Christine Greer, another entry level accountant who reported to Dean Helton.

Kris Duffy testified that at the meeting Ealey assigned Stachowicz and Greer to work on a "special project" under Ealey's supervision to research possible reclassifications and to report back to Ealey. Ealey also reported at the meeting that he had been asked to work on the project by Stratton. Early in the meeting, Ealey discussed the SCANA decision and the concept of allowed return and above and below the line reporting. Stachowicz and Greer were also asked to determine the impact of the reclassifications on Duke's earnings before interest and taxes (EBIT) and were told to coordinate one issue (deferred executive compensation) with Heidelburg and another accountant. Both Stachowicz and Greer prepared notes of the meeting. Their notes reflect the purpose of the meeting and the subjects covered. Stachowicz testified that Ealey did most of the talking and that for the most part her notes reflect Ealey's comments.

6. December 17, 1998 meeting at Boyer's office

On December 17, 1998, Jeff Boyer, Duke Energy Controller at the time, Sarah Heidelburg, Duke Energy Director of Corporate Accounting, Don Stratton, Duke Power's Manager of Rates and Regulatory Affairs, and Cary Flynn, Vice President Corporate Tax, all met at Boyer's office and discussed, among other subjects, the possible transfer of a tax reserve from PanEnergy (another Duke Energy affiliated company) to Duke Power. One of the concerns expressed at the meeting was whether there would be an above or below the line impact from such a transfer.

7. Stachowicz and Greer – work between December 17, 1998, and January 5, 1999

Christine Stachowicz and Christine Greer went to work on the "special project" to which they had been assigned at the December 17, 1998 meeting in Ealey's office – researching possible reclassifications of expense/income items from/to "above the line." Both were entry-level accountants at Duke. Neither had any prior experience with regulatory accounting or the USOA. The Uniform System of Accounts is the prescribed system of general ledger accounts for regulated public utilities provided for under the Federal Power Act. It defines how assets, liabilities, revenues, and expenses should be classified for any regulated utility. Utilities operating in accordance with the provisions of the Federal Power Act are to establish their chart of accounts consistently with the structure described in the Uniform System of Accounts.

The two consulted a copy of the USOA lent to them by Ealey or Helton. They each testified that they spoke to several other employees, but did not seek input from Deloitte & Touche, Duke's outside accounting firm, or any other external reference sources, including information about industry practices. Through the end of December 1998 both consulted with each other in preparing various spreadsheets or templates outlining various "strategies" with the "objective" of reclassifying certain income or expense items. One such spreadsheet (See Exhibit C attached) states, in part, "for the last two quarters in 1998, Duke Power has being (sic) earning a higher rate of return than allowed by the current rate structure. We have come up with the following strategies to reduce Duke Power's current rate of return."

The "strategies" preliminarily identified by Stachowicz and Greer were Merchandising, Insurance Refunds, Executive Deferred Compensation, Hub transactions and allocated costs. Ultimately, the two determined that adjustments in the last two areas would not be appropriate. The spreadsheets they prepared address in detail the various accounting entries that would have to be made to achieve the objective of reclassifying various expenses or income items, and analyze their above and below the line impact, as well as their impact on EBIT (Earnings Before Interest and Taxes).

8. Work of others at Duke between December 17, 1998, and early January 1999

Heidelburg had a discussion during this period with Ealey about possible reclassifications. In early January 1999, Boyer had discussions with Stratton and Heidelburg about moving nuclear refunds "below the line". Meyer met with Ealey about the reclassification research at about the same time that Stachowicz and Greer completed their research.

9. Sunday, January 3, 1999

Sarah Heidelburg prepared a spreadsheet showing corporate level Year-End Special Entries, including reversal of the Price-Anderson entries and Tax Transfer issues (See Exhibit D attached). This document, bearing a date and time of 1/3/99 at 5:26 p.m., noted for nuclear insurance "move nuclear refunds from above to below the line" and for "Price Anderson-reverse from above the line and credit reserve (as we did prior to '98) and move income impact below the line" so that there is "no net income impact." Grant Thornton believes that this "Price Anderson" comment is especially significant. As explained in more detail later in this report, this entry recorded, on January 8, 1999, an expense above the line. That entry was reversed five minutes later, ostensibly to correct a mistake made in the recording, but the reversal was recorded (ostensibly also in error) to "below the line." The January 3, 1999 spreadsheet reveals that Duke accountants had identified making the entry and reversing it incorrectly as a strategy to reduce the earned return reported to the State Commissions, five days before the ostensible "mistaken" entries were made.

10. Tuesday, January 5, 1999

On Tuesday January 5, 1999, Duke Power's Assistant Controller Rick Ealey sent emails to a number of individuals, including Meyer and Helton, reporting that "we are currently looking at reclassification entries as discussed with Don Stratton to help with our 'allowed return' problem. In our efforts to manage sometimes conflicting goals of EBIT, Allowed Return and O&M incentive goals, we get boxed in and cannot accommodate all of these…" (See Exhibit B attached).

Christine Stachowicz and Christine Greer met with Ealey to discuss their preliminary findings, in preparation for their meeting with Stratton. They provided their spreadsheets to Ealey. The spreadsheets were edited, at Ealey's direction, before being shared with Stratton. Greer had a telephone conversation with Stratton. A spreadsheet (see Exhibit E attached) was prepared showing the effect of the allowed return reclassifications on EBIT and EIP (employee incentive plan). Greer made notes on this spreadsheet, which she believed had been prepared by Helton or delegated to someone by Ealey. Helton and Ealey both deny having authored the spreadsheet. In fact, no one at Duke acknowledged authoring this spreadsheet or could identify who did prepare it. This document is critical evidence of the existence of a coordinated plan to reclassify or adjust expenses to enhance Duke Power's regulatory position, without jeopardizing Duke Energy's consolidated earnings reported to investors or the employees' and executives' incentive program. This spreadsheet evaluates accounting entries or adjustments, which were later addressed in the Duke Report. Grant Thornton believes that this spreadsheet is persuasive evidence that Duke Power engaged in a coordinated effort to make regulatory reclassifications and/or adjustments without impacting EBIT or incentive program goals. This spreadsheet compares in detail the impact of such entries on corporate and Duke Power EBIT, the O&M/A&G base for incentive compensation and the company's regulatory earned return.

11. The Approval of the Reclassifications and Adjustments

On Thursday, January 7, 1999, Greer and Stachowicz met with Don Stratton in his office—at Rick Ealey's request—to present their reclassifications. Stratton gave Stachowicz and Greer specific guidance and feedback. In the meeting, at which the two accountants reported to Stratton that they had identified only $48 million in adjustments, Stratton said "he would have liked $100 million." At one point during the meeting, Stratton told the two that he would talk with Boyer and Ealey about some of the suggested adjustments. Stachowicz's revised spreadsheet for "Executive Deferred Compensation above the line" reflects changes made earlier to accommodate Ealey's suggestions, as well as notes of suggestions made by Stratton. One note reflecting Stratton's comments states that "if we say below line exp, stockholders pay; no revenue stream from stockholders to pay it…looking at ways to justify earnings above line-what exp[ense] to put above line. They may put other exp[ense] above for rptg purposes even if not in rate calc."

12. Closing of the Books and Related Matters

On Friday, January 8, 1999, Duke Energy Controller Jeff Boyer discussed nuclear insurance with Don Stratton. Between Thursday, January 7, 1999 and Saturday, January 9, 1999, a number of the actual reclassifications and/or adjusting entries were made to Duke's December 1998 General Ledger, mostly by lower level members of the accounting staffs of Duke Power and Duke Energy Controllers' departments.

On Sunday, January 10, Christine Greer met with Rick Ealey. Although Greer has no specific recollection now of the details of the discussion, she does remember making notes on a spreadsheet (See Exhibit E attached), similar to the one later circulated by Dean Helton as (See Exhibit F attached), most likely reflecting the discussion with Ealey. Grant Thornton believes that the spreadsheet (See Exhibit E attached) was likely prepared by Ealey or someone reporting to him.

13. Monday, January 11, 1999

On January 11, 1999, the December 1998 books were formally closed at the Duke Power business unit level. At 10:34 a.m., Rick Ealey sent Sandra Meyer an email identifying various reclassification issues, which was forwarded to Helton, among others. This email identified the Hydro study double expense and addressed the tax entries. The email also stated that "Don tells me Sarah has a spreadsheet on all the impacts of what they did on tax adjustments…". At 1:10 p.m., Helton sent an email with attached spreadsheet (See Exhibit F attached) showing the allowed return adjustments and the effect that the adjustments had on EIP. The spreadsheet identified virtually all of the fourteen accounting issues addressed in the August 2001 Duke Report.

At 1:07 p.m., prior to the closing of the general ledger for 1998, Ealey sent an email to Helton and Duffy stating they did not need to reverse the $1.2 million double counted Hydro entry until January 1999.

14. Wednesday, January 13, 1999

On January 13, 1999, after Duke had closed its general ledger for 1998, Duke recorded a second entry related to Asbestosis Injuries and Damages. This entry was recorded off the ledger for 1998, as an adjustment to opening balances in the Fiscal 1999 general ledger. The entry was for $5 million, and was included in all filings with the State Commissions for 1998 as an increase in utility operating expenses. In Grant Thornton's opinion, the significance of this entry is that it demonstrated that Duke could have reversed the Hydro Study error which, was known before the 1998 books were closed, contrary to what Duke employees had testified.

15. Reconciliation of Regulatory Reclassifications with the Incentive Program

At 10:49 a.m. on Thursday, January 14, 1999, Dean Helton sent an email (See Exhibit G attached) to a number of Duke managers, including Ealey, stating that he and Meyer had completed "the review of the EIP/STIP information" the line of business managers had submitted to them earlier. The email identified seven adjustments that had "been approved as exceptions," including "Price Waterhouse (sic) entry," Insurance refund entries, executive compensation and double counting of Hydro Study Write-Off Costs.

The email stated that Meyer "still plans on running this by Bill Coley." STIP and EIP are acronyms for Duke Power's employee and executive incentive programs. The amount of incentive bonus paid for each line of Duke's business was based, in part, on each unit's success at keeping Operating and Maintenance (O&M) expenses and Administrative and General (A&G) expenses below certain target totals. While an increase in "above the line" expenses caused by the reclassifications and adjustments which were being considered in reaction to the SCANA decisions would benefit Duke by reducing its earned return reported to the State Commissions, Duke personnel were concerned that their bonuses/incentive payments would also be reduced. Accordingly, consideration was being given to treating some of the items as "exceptions," that is the expense would be recorded "above the line," reducing utility operating income reported to the State Commissions, but certain items would not be allowed to impact the bonus/incentive compensation calculations.

Meyer then met with Duke Power CEO Bill Coley about the approved exceptions. At 1:48 p.m. Meyer sent an email on EIP/STIP to a number of Duke Power management level employees stating “Bill Coley has confirmed the ‘exceptions’ communicated earlier by Dean Helton for our 1998 O&M/A&G measures.” Meyer wrote that “I place ‘exceptions’ in quotes because the majority of these were actually adjustments to get actual results on a comparable basis with budgets.”

V. Detail of Findings Relative to Specific Accounting Entries

A. Reclassifications or Adjustments which were completely without justification under any accepted accounting standards.

1. Price Anderson Entries

a. According to the August 28, 2001, Duke Report:

“This issue relates to a charge of $1.75M to account 924-Property Insurance Expenses during 1998. Prior to 1998, Duke Power charged amounts to account 924-Property Insurance Expense to reflect the annual cost of an internal insurance reserve related to nuclear property liability claims associated with the Price Anderson Act. The accounting each year resulted in a charge to account 924 and a credit to account 228-Accumulated Provision for Property Insurance, an operating reserve account. The entry occurred each year from 1978 to 1996 and resulted in a reserve balance of approximately $28.5M. This reserve balance was capped at $28.5M at the end of 1996 as part of the nuclear insurance reserve assessment referred to above.

At year-end 1998, an entry charging account 924 for $1.75M was made with an offsetting credit to account 228. The reserve account entry was reversed; however, the offsetting credit was incorrectly made to account 421, a non-operating account. These accounting entries resulted in a charge to an electric utility expense account and a corresponding credit to a non-operating expense account.”

b. Grant Thornton’s Findings:

Each year from 1978 to 1996, Duke Power recorded, in connection with the Price Anderson Act, a reserve on its books for public damages that might arise from operating Nuclear Power Plants. The amount of this entry was approximately $1.75M per year in each of the ten years prior to, and including, 1996. Prior to 1987 the annual accrual was at an amount less than $1.75M because there were fewer nuclear units on-line then. The total amount accumulated on Duke’s balance sheet as a reserve for this liability was $28.5M at 12/31/96, 12/31/97, and 12/31/98.

Duke’s 1997 Treatment

For the first 8 months of fiscal 1997, Duke recorded an expense (in account 925) and an increase in the related accrued liability account 228, of $145,833 per month ($1.75M divided by 12 months), as it had in prior years.

At some point during 1997, Duke management decided to cap the balance sheet reserve at its December 31, 1996, level.

Accordingly, in September 1997, the Company began to reverse the year-to-date expense recorded in FY 1997.

By December 1997, all of the 1997 expense which had been recorded by Duke relating to the Price Anderson reserve account during the first 8 months of 1997 had been reversed. No year-end 1997 adjustment was made.

Duke's 1998 Treatment

No fiscal 1998 activity appears in general ledger account 228.13, nuclear insurance liability reserve, until December 1998. The first of two entries to this account in the December 1998 ledger was recorded on January 8, 1999. The entry was posted to record a Price Anderson liability for 1998 as follows:

Account	Acct #	DR	CR
Injuries & damages – other	925.20	$1,750,000	
Nuclear insurance liab., reserve	228.13		$1,750,000

The entry was recorded at 9:42 PM by Diane Neely Matthews, was initialed by Gregory Massey, and was approved by Sarah Heidelberg.

A second entry was recorded at 9:47 PM on the same day (01/08/99) by Matthews; it was also initialed by Massey, and was again approved by Heidelberg. This second entry reversed the above described Price Anderson entry, as a debit to account 228.13 for $1.75M, and a credit to account 421.31, sundry revenues, for $1.75M, as follows:

Account	Acct #	DR	CR
Nuclear insurance liab. reserve	228.13	$1,750,000	
Non-operating Sundry Revenues	421.31		$1,750,000

The effect of the above two entries was to record an expense "above the line", but reverse it "below the line". It is Duke's position (per their August 28, 2001 Report) that the credit portion of this entry was an error. However, their Report offers no explanation of what to do to correct the error.

Further, Duke Power contends, subsequent to their Report, that a 1978 North Carolina rate order (1978 E-7 Sub 237) required Duke Power to cap this reserve at the end of ten years. In addition, Grant Thornton notes in Duke's 1986 rate case the annual accrual and cost of service charge for Price Anderson is established at $1,750,000. Further, in Duke's 1991 rate case (Duke's most recent rate case) Duke was allowed an annual cost of service charge of $1,750,000 without any mention of a cap on the reserve.

The two entries, the recording of the liability and its subsequent reversal to a "below-the-line" account, lowered Duke's 1998 earned return, as reported to the State Commissions, but had no effect on the net income reported to shareholders or to the Securities and Exchange Commission.

Certain Duke employees participate in bonus and incentive programs. The amount paid to employees in connection with such programs is based, in part, on Duke operating units' success at keeping expenses below certain target levels. On or about January 14, 1999, the Price Anderson entry was approved as an "exception" for the 1998 bonus calculations. Duke management decided not to charge this item as an expense in the calculations involving employee bonuses, even though it had been charged as an expense in the calculation of Duke's earned utility return. In 1996, the Price Anderson entries were charged as an expense in the calculation of Duke's utility-related earned return and the entries were not treated as an exception for 1996 bonus calculations.

Duke's Treatment 1997 vs. 1998

For 1997 Duke did not record a charge to account 924 with a corresponding credit to account 228 an operating reserve account, because Duke made a decision to cap the Price Anderson reserve at $28.5M.

For 1998 Duke in essence recorded a charge in the amount of $1.75M to account 925 an "above the line" expense account with an offsetting credit to account 421 a "below the line" non-operating revenue account.

Grant Thornton's Conclusions:

Grant Thornton found that Sarah Heidelburg, Duke's Director of Corporate Accounting, prepared a spreadsheet (See Exhibit D attached) regarding "Year-End Special Entries", which bears a date of 01/03/99. In connection with the Price Anderson entry the document states "…reverse from above-the-line and credit reserve (as we did prior to '98) and move impact below-the-line…." so there is "…no net income impact". This document appears to indicate that the incorrect reversal of the Price Anderson entry was contemplated five days before the ostensible "mistake" was made.

Neither the Duke Report nor Duke employees offered any reasonable explanation as to why the 1998 Price Anderson entry was made or why the offsetting credit to reverse the entry was recorded to a "below the line" account five minutes after the expense was charged to an "above the line" account. No one was able to explain the circumstances under which the "comments" in the "Special Entries" spreadsheet were prepared stating that "Price-anderson reverse from above the line and credit reserve (as we did prior to 98) and move impact below the line." Sarah Heidelburg testified she would not have made either Price Anderson entry without direction from Jeff Boyer. Jeff Boyer, along with then Duke Energy CFO Richard Osborne, had made the decision in 1997 to cease recording any further reserve relating to Price Anderson.

Based on our investigation and Duke's admission that an inappropriate entry had been made, we recommend that Duke Power amend its 1998 FERC Form 1 and quarterly filings with the State Commissions of North and South Carolina. Account 421 should be reduced by $1,750,000 and the reserve account 228 should be increased by the same amount in the amended filings.

This recommendation is based on the premise that the 1991 rate case treatment (allowing $1,750,000 in cost of service) would prevail over a prior accounting order.

Further, because Duke capped the Price Anderson reserve in 1996 without approval of the State Commissions, we recommend that Duke amend its FERC Form 1 and quarterly filings for the years 1997, 1999 and 2000 by accruing $1.75M each year in account 228 with the offsetting debit to account 925 in order to be in compliance with the accounting treatment accepted by the State Commissions in Duke Power's last rate case(s). In the future when Duke desires to change its method of accounting from what was previously agreed to in a rate-case Duke Power should seek the approval of the applicable State Commission.

Further, if the Commissions of North and South Carolina were to interpret that the 1978 accounting order prevails over a subsequent rate case with respect to a cap on the Price Anderson Act reserve then our recommendation would be that Duke Power amend its 1998 FERC Form 1 and quarterly filings with the State Commission of North and South Carolina by reducing (debit) account 421 sundry revenues by $1,750,000 and reducing (crediting) account 925 injuries and damage expense by $1,750,000.

2. **Income Tax Entries**

   a. **This series of 1998 year-end entries is not discussed in the August 28, 2001, Duke Report, except for a footnote reference on page 3.**

   b. **Grant Thornton's Findings:**

Duke undertook a complex series of 1998 year-end general ledger entries which, among other things, transferred a $25,000,000 tax-related reserve ("cushion") from a non-electric regulated Duke Energy affiliate, PanEnergy, to Duke Power. This related party transfer was effected in a manner which resulted in an inappropriate understatement of Duke Power's earned return as reported to the State Commissions, but had no effect on Duke Energy's net income reported to its investors and to the SEC. The complex series of 1998 year-end general ledger entries through which this was accomplished also included numerous entries related to an IRS audit of Duke (recording an estimated assessment totaling $71,543,052) and a $7,381,807 refund from the North Carolina Department of Revenue.

The cumulative effect of Duke's 1998 year-end entries related to PanEnergy, the IRS audit, and the North Carolina Department of Revenue refund on the Duke Power Income Statement and Balance Sheet was as follows:

	(Dr) Cr
• Balance Sheet: assets decreased by $39,161,245	
Estimated IRS Assessment payments	$71,543,052
North Carolina DOR refund	(7,381,807)
Receivable recorded from Related Party	(25,000,000)
	$39,161,245
• Balance Sheet: liabilities decreased by $39,161,245	
Income Tax Liabilities	$(14,229,984)
Miscellaneous Liability Account	(24,931,261)
	$(39,161,245)
• "Above the Line" Income: decreased by $17,745,703	
Income Tax Expense moved from "below the line"	$(25,000,000)
Income Tax moved from a liability account	7,254,297
	$(17,745,703)
• "Below the Line" Income: increased by $17,745,703	
Income Tax Expense moved "above the line"	$25,000,000
Interest Expense (net of other P&L entries)	(7,254,297)
	$17,745,703

Internal Revenue Service Audit

During and prior to 1998, Duke Power was audited by the Internal Revenue Service (IRS) for tax years 1986 to 1994. The audit was settled in 2001. During fiscal 1998, Duke Power made payments to the IRS in September, October, and December to stop further interest from accruing on any final assessment. The total of these payments to the IRS was $71,543,052, of which $41,177,790 was designated as interest and $30,365,262 was designated as income tax liability. Duke initially posted these payments as a reduction of cash, with an offsetting debit to a balance sheet account, accrued federal income tax liability, general ledger account number 236.98.

Refund from North Carolina Department of Revenue

In 1998, Duke Power received a $7,381,807 refund from the North Carolina Department of Revenue: $4,282,059 relating to interest and $3,099,748 relating to state income taxes. Duke credited the interest to general ledger account 184, a balance sheet clearing account. The tax portion of the refund was credited to account 236, North Carolina income tax payable - prior year.

The Related Party Transfer from PanEnergy

On January 8, 1999, Duke Power recorded entries to adjust the interest portion of the above tax related entries and to adjust utility income taxes. In addition, in one entry, Duke Power transferred a $25,000,000 reserve "cushion" from PanEnergy, a related party entity to Duke Power. This entry had the effect of decreasing 1998 net utility operating income reported to the State Commissions by $25 million, but had no effect on the bottom line consolidated net income of Duke Energy. PanEnergy, the related party, is a natural gas utility that is not involved with electric operations in North and South Carolina, and is not subject to regulation by the State Commissions. Using this related party entry, Duke Power increased an "above the line" expense account, utility income taxes, account 409, by $25 million and recorded a corresponding credit to account 236, income taxes payable, a balance sheet account. Simultaneously, Duke Power reduced account 409, "below the line" income tax expense by $25 million, and recorded a debit to account 146, a related party receivable on its balance sheet.

Tax-Related Interest Calculations and Entries

Duke recorded 1998 year-end entries to reclassify the interest portion of the payments made to the IRS in connection with the ongoing audit. Duke Power's Rates and Regulatory Affairs Department prepared an analysis of Duke's allowed return position in December 1998 and early January 1999. The analysis used both the income tax portion and interest expense portion of the above mentioned entries as factors in its allowed return calculation for December 31, 1998.

Duke Energy's Director of Corporate Accounting, Sarah Heidelburg answered yes when asked in her deposition if one of the goals in making that shift or transfer (PanEnergy reserve transfer) was to do it in a way that did not adversely impact the bottom line. The corporate accounting department was assigned with the task of finding ways to offset the $41 million of interest expense. Duke used a tax reserve of $24.9 million and interest income on a state tax refund of $4.2 million to offset the majority of the interest expense. Duke increased account 426, a "below the line" other income account by $24.9 million, and decreased miscellaneous liability (balance sheet) account 253 for the same amount. Duke also increased "below the line" interest income account 419 for $4.2 million relating the state tax refund referenced above. The clearing account 184, a balance sheet account, was decreased as the offset to this entry.

The interest expense and income offset entries discussed above had no impact on net utility operating income, but did result in a decrease in Duke Power's total net income of $11,964,470:

$41,177,790
(24,931,261)
(4,282,059)
$11,964,470

Duke Power then recorded another entry to offset this $11.9 million impact on net income. Using its effective tax rate of 39.368%, Duke Power determined the $11.9 million reduced income tax expense by $4,710,173 (11,964,470*39.368%).

Duke then recorded another entry to reduce "above the line" utility income taxes by $7,254,297, with the offset to the income taxes payable account 236 for the same amount. The $7,254,297 derived amount of decrease in utility income tax expense is calculated by subtracting the tax effect of the interest entries ($4,710,173) from the net income impact of those entries ($11,964,470).

c. Grant Thornton's Conclusion

This series of entries resulted in Duke's underreporting net utility operating income to the State Commissions for 1998 by $17.7 million.

For purposes of preparing its 1998 Annual Shareholders Report, which is also filed with the SEC, Duke Energy reversed the above described entries. The income tax portion automatically offset itself (there is no distinction between "above the line" and "below the line" for income taxes in the Annual Shareholders Report). Duke Energy then recorded a reclassification entry to remove the $41 million of interest expense, the $4.2 million of interest income, the $24.9 million of old tax reserves, and the $11.9 million income tax reduction. Duke's Director of Financial Reporting testified that for SEC financial statement purposes Duke personnel wanted to treat the transaction as if the cash paid (for the IRS audit liability) was applied directly against the balance sheet reserves, and, therefore, Duke personnel reversed the income statement components of this transaction. Essentially, in its filings with the SEC, Duke Energy returned to its original accounting treatment for the IRS payments.

The only apparent reason for recording any of these entries was to reduce net utility operating income reported in its filings with the State Commissions, without impacting bottom line net income at all. Duke's report of August 28, 2001, does not describe this entry in detail. The only mention of this entry is a footnote (3) on page 3 of their Report.

In December 2000, Duke Power recorded an entry to reverse the $17,745,703 increase in utility income taxes which resulted from these entries in 1998. Duke eventually received a refund from the IRS for the payments relating to the IRS audit. When it became known in 2000 this was a likely outcome, Duke recorded a reversing entry decreasing utility income taxes by the $17.7 million, and correspondingly reduced the income tax payable account for the same amount. The net result of this entry was an increase of net utility operating income reported to the State Commissions for fiscal year 2000.

Based on our investigation, we recommend Duke Power conform its 1998 FERC Form 1 and state quarterly filings with the presentation reported in its Annual Shareholder Report and Form 10-K.

B. Reclassifications or Adjustments which were made in part inappropriately and without justification under any accepted accounting standards.

1. Merchandising

a. According to the August 28, 2001 Duke Report:

For some years prior to 1998, Duke Power had engaged in the sale of electrical appliances to the public. Duke Power referred to this activity/division of the company as Merchandising. According to the Duke Report, both the costs and revenues associated with Duke Power's Merchandising had historically/consistently been recorded in non-operating "below the line" accounts.

b. Grant Thornton's Findings

In 1998 Duke Power decided to discontinue Merchandising operations. At or near the end of 1998 Duke Power estimated the costs which would be incurred in connection with this discontinuance of Merchandising, and set up a reserve for such costs. Duke charged these estimated future costs ($50 million) to expense in 1998. Duke charged a little over $6.0 million of these costs to "above the line" expense. The Duke Report acknowledges that $5.1 million of that amount was inappropriate.

Grant Thornton analyzed worksheets prepared by Duke Power personnel which evidenced that careful consideration was given by Duke Power personnel in identifying future lease obligations costs and the remaining unamortized leasehold improvements associated with the Merchandising operations as of the end of 1998. In addition, Duke estimated the future operating and maintenance costs which would be incurred in connection with the wind down of Merchandising, and estimated signage removal costs which would be incurred. The total costs which Duke identified were:

Rents	$3,234,563.42
Ops and Maintenance	1,126,573.54
Amortization-leasehold improvement	927,010.00
Signage Removal	750,000.00
	$6,038,146.96

One of the strategies discussed at a December 17, 1998 Duke internal meeting regarding Duke Power's earned return issue was to record Merchandising discontinuation expenses "above the line". On January 8, 1999, a December 1998 adjusting journal entry was made to record the $6.038 million described above as an expense to utility operations ("above the line"). This reduced the pre-tax net utility operating income reported to the State Commissions.

c. **Grant Thornton's Conclusions:**

In all previous years the lease and maintenance expenses for the same facilities or portions of facilities which gave rise to the expense had been charged to Merchandising accounts "below the line", as they were not deemed used for electric operating purposes. The result of Duke's 1998 accounting for the Merchandising closeout accrual was an understatement of pre-tax utility operating income reported by Duke Power of $5.1 million. Duke, in its August 2001 Report, acknowledges $5.1 million was inappropriately recorded on Duke Power's 1998 books.

Duke records provided to Grant Thornton indicate that an additional $927,010 of amortization expense relating to merchandising leasehold improvements was recorded "above the line", for a total understatement of pre-tax utility operating income of $6.038 million.

On January 14, 1999 Duke Power management identified approximately $5.1 million of the $6.038 million charge as an "exception" for purposes of bonus calculations. Thus, while these Merchandising related, non-operating expenses were used to under report pre-tax utility operating income to the State Commissions, they were not allowed to impact the bonuses calculated for Duke employees.

Based on our investigation, we recommend that Duke Power amend (in the amount of ($6.038 million) its 1998 FERC Form 1 and quarterly filings with the State Commissions of North and South Carolina. The rent, maintenance, signage removal and amortization expenses should be charged to account 416, merchandising expense in the amended filings.

2. **Deferred Executive Compensation**

a. **According to the August 28, 2001 Duke Report:**

The issue involves Duke Power's accounting for the expense of certain executives' (of Duke Power) deferred compensation plans. The Duke Report indicates that Duke's "…review of the $15.9 million of costs related to 1998 shows that $4.8 million of the costs were related to Duke Energy affiliates and should have been charged to a non-operating account". On page 15 of the Duke Report, the "Impact" of the Executive Compensation issue is shown as $4.8 million. Duke's conclusion was that $4.8 million should have been charged to a non-operating account.

b. **Grant Thornton's Findings:**

Duke's Treatment Prior to 1998

Prior to 1998, Duke Power charged 100% of the expense for the Duke Power Deferred Compensation to general ledger account 426, a "below the line" account described in the Uniform System of Accounts as "other miscellaneous expenses, which are non-operating in nature".

Duke's 1998 Treatment

On or about January 8, 1999, an adjusting journal entry was made to Duke Power's December 1998 general ledger, adjusting approximately $15.9 million of deferred executive compensation from the 426 account, "below the line", to account 926.49, an "above the line" electric utility operating account. This 1998 reclassification was inconsistent with Duke's past accounting practices.

c. Grant Thornton's Conclusions:

The apparent intent of Duke Power's change (made effective for 1998 through the January 1999 adjusting entries described above) in accounting for deferred executive compensation was to allocate to "above the line" operating accounts the deferred compensation expense associated with all electric utility related executives. To the extent that the expense identifies with electric utility operations, the reclassification is appropriate (however, the State Commissions were not notified of this change).

Grant Thornton found that $4,837,541 of the total $15.9 million could be specifically identified with non-electric subsidiaries. Grant Thornton further identified an additional $645,344 that was adjusted to "above the line" operating accounts inappropriately. The majority of this amount relates to payments made to Duke Power retired employees or their qualifying survivor. Those payments are made under a plan to provide a supplemental retirement benefit to Duke retirees or their qualifying survivor. In prior years these payments were recorded below the line. Grant Thornton does not have a problem having a plan to pay retirees or their qualifying survivor a supplemental retirement benefit. However, the method of accounting for such payments is first inconsistent with past accounting practices (prior to 1998 these payments were recorded "below the line") and second, these payments should have been accrued in prior years when the now retired employees were employed by Duke Power. For the years 1999 and 2000 the inappropriate accounting amounted to $616,454 and $606,104, respectively.

On January 14, 1999, Duke Power management included the $5.5 million expense as an "exception" for the purposes of bonus calculations. In essence, the above mentioned $5.5 million was added back to utility operating income for purposes of the bonus calculations, making the income amount used in the bonus pool larger than the income amount reported to the State Commissions.

Based on our investigation, we recommend that Duke Power amend its 1998, 1999 and 2000 FERC Form 1 and quarterly filings with the State Commissions of North and South Carolina. Deferred executive compensation expense for retirees, non-electric subsidiaries and employees (amounting to approximately $5.5 million in 1998, $616,454 in 1999 and $606,104 in 2000) should be charged to account 426, where it had been previously recorded. In addition, if in the future, Duke wants to change its method of accounting from its last rate case or a previous accounting order, Duke should formally request an accounting order from the applicable State Commission(s).

C. Reclassifications or Adjustments were made under aggressive interpretations of the USOA that were contrary to applicable accounting principles, industry practice and Duke's past practices.

Nuclear Insurance Refund Entries

This issue involves Duke Power's handling of insurance premium refunds/distributions which Duke Power received. The expense of the related insurance premiums paid by Duke Power was charged to utility operating accounts; that is, the expenses were essentially passed on to and paid by electric ratepayers/consumers.

a According to the August 28, 2001, Duke Report:

This issue involves nuclear insurance distributions of $26.5M in 1998 which were credited to Non-operating Income. Prior to 1998, nuclear insurance distributions were credited to the balance sheet and utility operating accounts. Approximately four pages of the Duke Report attempt to explain and justify Duke's treatment of the 1998 distributions. On page 15, the Duke Report states, "At the time the Company treated such amounts as a below the line non-operating credit, the Company believed such treatment was appropriate. Based on our current research, the Company recognizes that general industry practice has been different." Further on page 15, the Duke Report, in a table, appears to acknowledge that $4 million of $26.5 million of nuclear insurance distributions should have been accounted for "as a credit to the insurance reserve."

b. Grant Thornton's Findings:

Duke's 1998 Treatment

In 1998, when $26,491,308 of insurance refunds were received by Duke Power as distributions from the mutual insurance companies, Duke Power recorded the distribution as a credit to the same "above the line" expense account to which the premium expense had been charged. This treatment is a generally accepted method for regulated utilities to account for insurance distributions, is consistent with Duke's historical practices, and is in accordance with the Uniform System of Accounts. The Uniform System of Accounts is the prescribed system of general ledger accounts for regulated public utilities provided for under the Federal Power Act. It defines how assets, liabilities, revenues, and expenses should be classified for any regulated utility. Utilities operating in accordance with the provisions of the Federal Power Act are to establish their chart of accounts consistently with the structure described in the Uniform System of Accounts. In December 1998, Duke Power made adjusting journal entries, which transferred Duke's entire insurance refunds ($26,491,308) to a non-operating general ledger account, "below the line". As a result, these refunds were not reported in utility operating accounts ("above the line"), and Duke's earned return reported to the State Commissions was reduced pre-tax by $26,491,308 for 1998.

Nuclear Mutual Limited (NML) Insurance

Duke paid insurance premiums to NML for primary property insurance on Duke's nuclear facilities. Duke received annual distributions (refunds) from NML for current and accumulated earnings of the mutual insurance company. Prior to 1998, refunds Duke received from NML were credited to account 228.11 – nuclear property insurance reserve, a balance sheet account. This accounting practice was accepted by its regulators in North and South Carolina in Duke's last rate case(s). In 1997, the amount credited to this reserve account for NML refunds was $8,306,867.

In fiscal 1998, Duke's initial accounting of its NML refunds ($8,659,803) credited the refunds directly against property insurance expense, general ledger account 924.98, an "above the line" operating account. This accounting treatment was a change from its prior practice. In December 1998, Duke adjusted $8,659,803 of the NML refunds from account 924.98 to account 421.31 – sundry revenues, which is a "below the line" miscellaneous income account. Duke in essence changed its accounting policy for those refunds by reporting them as credits to its income statement and not as a credit to the balance sheet liability (reserve) account. Duke did not request an accounting order or approval from the State Commissions having jurisdiction over its regulatory operations to change its accounting. Further, this 1998 change in accounting is not consistent with how Duke in its last rate case(s) accounted for the NML refunds. In addition, various Duke personnel testified these NEIL and NML refunds were "material", "major" and "large." However, Duke failed to disclose these material/major accounting changes in the 1998 FERC Form 1, as required by the Form's instructions.

Nuclear Electric Insurance Limited (NEIL) Insurance

Duke has secondary property insurance, as well as business interruption insurance with NEIL. Duke has received annual refunds from NEIL for many years. Prior to 1998, Duke recorded the refunds as a credit directly against the premium expense for this insurance in general ledger account 924. In 1997, NEIL refunds of $10,799,795 were credited to this "above the line" expense account.

During 1998, NEIL refunds ($15,728,013) received by Duke were initially recorded as credit to the "above the line" expense account in which the related premiums were charged, as had been done in previous years. In December 1998, however, the entire $15,728,013 of the 1998 NEIL refunds were adjusted to account 421.31 – sundry revenues, a "below the line" miscellaneous income account.

Other Nuclear Insurance

Duke has additional insurance on its nuclear facilities with two carriers, American Nuclear Insurers (ANI) and Mutual Atomic Energy Liability Underwriters (MAELU). Duke received annual refunds from these carriers. Prior to 1998, Duke recorded these refunds as a credit directly against the "above the line" account in which the premium expense was recorded.

During 1998, Duke received refunds ($2,103,492). Initially, the $2,103,492 was credited to account 924, property insurance, the same general ledger account in which the premium expense was charged. Duke recorded an adjusting journal entry in December 1998 to reclassify the entire $2,103,492 of these refunds to account 421.31 – a “below the line” miscellaneous income account.

c. Grant Thornton’s Conclusion:

The Uniform System of Accounts calls for refunds/distributions such as those received by Duke Power to be credited to the accounts to which the premiums were charged. This treatment is consistent with Duke’s policy prior to the posting of the December 1998 adjusting entries. In Grant Thornton’s opinion, the adjusting/reclassification entries posted to the December 1998 ledger by Duke inappropriately reclassified $26,491,309 of refunds “below the line”, in the non-operating section of Duke Power’s accounts, resulting in an understatement of Duke’s earned return as reported to the State Commissions.

In the conclusion of the Duke Report, Duke Power acknowledged that “…. general industry practice” has been different than the manner in which the December 1998 adjusting entries treated these refunds. However, in computing the impact of Duke Power’s incorrect handling of $26.5 million of these refunds for 1998, the Duke Report reflects only a $4 million “impact” not the entire $26.5 million of actual refunds received.

The Duke Report indicates on page 15 that “at the time the company treated such amounts as a below the line non-operating credit, the company believed such treatment was appropriate”. Nevertheless, Grant Thornton found that in the 1998 Consolidated Form 10K for Duke Energy Corporation (which includes Duke Power), filed with the Securities and Exchange Commission, Duke Power classified the entire $26.5 million as a reduction of operation and maintenance expense, so that the refunds are reported in operating income. In addition, in January 1999, at or about the same time as the December 1998 $26.5 million journal entries were being made, Duke Power decided that for the purposes of calculating bonuses for certain Duke employees, the appropriate place to acknowledge the $26.5 million was as a reduction to operation and maintenance expense. Duke’s treatment of the refunds afforded to Duke employees and investors differed from that reported to the FERC and the State Regulatory Commissions of North and South Carolina.

In a footnote on page 6 of its August 28, 2001 Report, Duke states: “In the annual report to stockholders and SEC filings, revenues and expenses are required to be grouped by business segment for the derivation of consolidated earnings before interest and taxes. Thus, since the (nuclear insurance) distributions received related to the electric segment of the Company, the amount was reclassified to Electric Operations for these reporting purposes.”

Grant Thornton believes that the explanation provided by Duke in its August 28, 2001 Report to the State Commissions for why there were different treatments of nuclear insurance distributions in its filing with the FERC versus its filing with the SEC is not correct. In the segment reporting disclosures in Duke Energy's annual report to the SEC, there is no way to differentiate between nuclear insurance refunds as a component of other income and nuclear insurance refunds as a component of operations and maintenance expense. Therefore, no income statement reclassification would have been necessary to comply with segment reporting. Furthermore, Duke Energy's Director of Financial Reporting testified that the treatment of nuclear insurance reclassifications in the 1998 annual report would not have impacted segment reporting in any way.

Duke Energy's 1998 Annual Report to Shareholders says in note 3, on page 46: "electric operations (business segment) are subject to the rules and regulations of the FERC, North Carolina Utilities Commission (NCUC) and the Public Service Commission of South Carolina (PSCSC)." Therefore, according to Duke Energy's annual report, the nuclear insurance distributions were reported as regulated activities.

Duke Power has obtained an affidavit from John J. Gillen, a partner with PricewaterhouseCoopers LLP for the purpose of providing an independent expert assessment of Duke Power's accounting treatment of distributions Duke Power received in 1998, 1999 and 2000 from the nuclear mutual insurance entities, Nuclear Mutual Limited (NML) and Nuclear Electric Insurance Limited (NEIL). (Document Attached as Exhibit H). Gillen's affidavit concludes, page 5, paragraph e "Duke Power's accounting for the 1998, 1999, and 2000 NEIL distributions as items of miscellaneous non-operating income in FERC Account 421, is an acceptable accounting treatment because the NEIL distributions are comprised of funds derived from positive investments gains." Grant Thornton LLP respectfully disagrees with Gillen's conclusion and is of the opinion that the 1998, 1999 and 2000 NEIL distributions should be accounted for as credits to the same account (924) that premium expense was recorded. In addition, Grant Thornton has obtained an affidavit (Document Attached as Exhibit I) from Martin J. Coe for the purpose of providing an independent expert assessment of Duke Power's accounting treatment of insurance distributions Duke Power received in 1998, 1999 and 2000 from the nuclear mutual insurance entities, Nuclear Mutual Limited (NML), Nuclear Electric Insurance Limited (NEIL), American Nuclear Insurers (ANI) and Mutual Atomic Energy Liability Underwriters (MAELU). Coe's affidavit concludes, page 6, par. 31 "Duke Power's accounting for 1998, 1999 and 2000 NEIL, ANI, MAELU and NML distributions as items of miscellaneous non-operating income in FERC 421, is not an acceptable accounting treatment".

The Uniform System of Accounts calls for refunds/distributions such as those received by Duke Power to be credited to the accounts to which the premiums were charged. This treatment is consistent with Duke's policy prior to the posting of the December 1998 adjusting entries. In Grant Thornton's opinion, the adjusting/reclassification entries posted to the December 1998 ledger by Duke inappropriately reclassified $26,491,309 of refunds "below the line", in the non-operating section of Duke Power accounts, resulting in an understatement of Duke's earned return reported to the State Commissions.

Duke's 1999 and 2000 Treatment

In 1999, Duke Power recorded insurance refunds of $22,903,647 initially as credits to account 924, then reclassified the entire refunds in the same month to "below the line" account 421, miscellaneous non-operating income. The $22,903,647 is included in miscellaneous non-operating income in the 1999 FERC Form 1, page 117, line 37 balance of $96,544,259.

ANI and MAELU insurance refunds aggregating $438,247 were recorded as miscellaneous non-operating income in the 1999 FERC Form 1, page 117, line 37 balance of $96,544,259.

In 2000, Duke Power recorded its entire insurance refunds of $33,940,808 as non-operating miscellaneous income in account 421, below the line. The $33,940,808 is included in miscellaneous non-operating income in Duke's 2000 FERC Form 1, page 117, line 37 balance of $85,035,905.

ANI and MAELU insurance refunds aggregating $651,693 were recorded as miscellaneous non-operating income in Duke Power's 2000 FERC Form 1, page 117, line 37 balance of $85,035,905.

Based on our investigation, we recommend Duke Power amend its 1998 FERC Form 1 and quarterly filings with the Commissions of North and South Carolina. The NML portion of nuclear insurance refunds ($8,659,803) included in miscellaneous sundry income account 421.31, should be recorded in the reserve account 228.11 – nuclear property insurance reserve. The other nuclear insurance refunds (amounting to $17,831,505) included in account 421.31, should be recorded in account 924 – property insurance in the amended filings.

Further, based on our investigation, we recommend Duke Power amend its 1999 and 2000 FERC Form 1 and quarterly filings with the Commissions of North and South Carolina. The NML portion of 1999 and 2000 nuclear insurance refunds of $8,555,214 and $10,579,819 respectively included in miscellaneous operating income account 421.31 should be recorded in the reserve account 228.11 nuclear property insurance reserve, for each year. The other nuclear insurance refunds amounting to $14,786,680 for 1999 and $24,012,682 for 2000 included in account 421.31 should be recorded in account 924 – property insurance in the amended filings, for each year.

D. Duke took advantage of accounting errors with the purpose of enhancing its earned return position.

1. Hydro Study Write-Off Costs

a. According to the August 28, 2001 Duke Report:

Duke examined the feasibility and implications of dam stabilization and seismic impacts on four Duke Power hydro stations. These studies cost approximately $1.2 million and were recorded in balance sheet accounts 183 and 107. At December 31, 1998, following a determination that the subject projects were not going to occur, the study costs were written-off to account 543-Maintenance of Reservoirs, Dams and Waterways, an "above the line" electric utility expense account. The entry to write-off the study costs was recorded twice. "The error was discovered after the general ledger was closed for 1998 and a correction entry was booked in early 1999." The correcting entry, however, credited the hydro study cost "inappropriately" to account 426.5-other deductions, a non-operating account.

b. Grant Thornton's Findings:

The entry to write-off the study costs was recorded twice. In both instances, the "above the line" expense account 543 was increased by $1,238,267, and the balance sheet accounts were reduced by the same amount. The entry was recorded the first time on January 8, 1999 at 6:52 PM. The duplicate entry was recorded on January 9, 1999 at 4:01 AM.

This error was detected as early as January 11, 1999 at 10:34 AM, the same day the general ledger was closed for the year. Duke Power's assistant controller decided not to correct this error in fiscal year 1998 before the general ledger was closed for the year. The effect of the double posting of this entry was to incorrectly overstate 1998 utility operating expenses reported to the Commissions by $1,238,267.

When Duke Power attempted to correct this error in the 1999 general ledger, they incorrectly posted the correction to a "below the line" miscellaneous expense account. This correcting entry was booked as a debit to the same balance sheet accounts, 183 and 107, for $1,238,267, and a credit for the same amount to account 426, a miscellaneous income/deductions account "below the line". A Duke Power accountant testified that the reason for recording this January 1999 correction "below the line" was that management did not want to give the Hydro department any advantage towards its O&M incentive goals in 1999 for an accounting error. Because Duke management did not want its Hydro department employees to have any unearned benefit in their incentive goals, they incorrectly understated pre-tax utility operating income reported to the Commissions by $1,238,267 in 1999.

On January 14, 1999, Duke Power management approved the handling of this expense as an "exception" for the purposes of 1998 bonus calculations. The $1,238,267 was added back to pre-tax utility operating income only for the bonus calculation, making the income amount used in the bonus pool larger than the pre-tax income figure reported to the State Commissions. In other words, this expense was inappropriately deducted in the report to the Commissions, resulting in an understatement of pre-tax utility operating income reported by Duke Power, but the error was not allowed to impact the bonus calculation for Duke Power employees.

c. Grant Thornton's Conclusions:

Based on Grant Thornton's investigation, the double posting error was discovered before the 1998 general ledger was closed, not "after" as the Duke Report suggests. Had Duke corrected the error within the 1998 general ledger, the pre-tax income reported to the State Commissions would have been $1,238,267 higher.

Based on our investigation, we recommend Duke Power amend its 1998 FERC Form 1 and quarterly filings with the Commissions of North and South Carolina. Duke should correct the double posting (in the amount of $1,238,267) of the Hydro study cost write-off in its amended 1998 filings.

2. Incentive Accruals

a. This series of 1998 year-end entries are not discussed in the August 28, 2001, Duke Report.

b. Grant Thornton's Findings:

Duke Power has incentive bonus plans for employees. The Employee Incentive Plan (EIP) is a bonus payable to employees of Duke Power. This bonus plan involves company financial performance, and an estimate (accrual) is made at year-end for the expected payout in the next fiscal year.

In May 1998, Duke Power "trued-up" the 1997 year-end EIP accrual to reflect the amounts actually paid in 1998. This entry resulted in credits (decreases) to "above the line" 500 series of expense accounts in the amount of $222,632 and credits to "above the line" 900 series of expense accounts in the amount of $101,859, with the off-sets to balance sheet liability accounts.

Estimates of the amount of EIP Incentive to be paid for 1998 were found in the documents provided by Duke Power to Grant Thornton. These estimates in part, are summarized in the table below.

	Information as of:	
	1/7/1999	**1/20/1999**
Salaries	$700,114,677	$700,008,991
EIP Estimate	35,291,700	36,446,263
EIP Amount Actually Paid		$ 36,451,858

An estimate was done on January 7, 1999, at which point the EIP liability was estimated at $35,291,700. At the time, the general ledger reflected an EIP accrued liability of $41,984,739. A journal entry was made on January 8, 1999 at 7:45 PM, reducing the EIP accrued liability by $1,708,399 to $40,276,340, which was the ending balance for the EIP accrual in the December 31, 1998 general ledger. That ending balance was approximately $5 million more than the estimate calculated by Duke Power personnel on January 7, 1999.

Per Duke's payroll register, the actual amount paid in 1999, for the 1998 bonus, was $36,451,858. The difference between the December 31, 1998, $40,276,340 liability balance and the $36,451,858 paid in 1999, resulted in a January 1999 EIP true-up entry in the amount of $3,824,482.

c. Grant Thornton's Conclusions:

Had Duke's accruals been corrected at year-end 1998, the incentive-related expense recorded for 1998 would have been approximately $3,824,482 lower ($40,276,340 - $36,451,858). Of that amount, $2,744,000 impacted "above the line" expense accounts.

The entries resulted in a $2,744,000 understatement of pre-tax utility operating income reported to the State Commissions for fiscal year 1998. The amounts were adjusted in fiscal year 1999 through the true-up journal entries. Based on the documents reviewed, it appears that Duke Power personnel knew they were over-accrued by as much as $5 million before the 1998 general ledger was closed, but only recorded an adjusting entry to reduce the over-accrual by $1.7 million.

A Duke Power accountant testified that Duke begins to monitor the EIP accrual in June to determine its accuracy. Normally, they then make a close estimate of the projected EIP payout in November, using actual payroll data, in an effort to avoid a large adjustment at year-end or subsequent to year-end. Duke prepared an analysis of the EIP payout on January 7, 1999 that projected the payout to be $35.3 million, when Duke still had an accrual of approximately $42 million on the general ledger. Duke adjusted this estimate only slightly, by $1.7 million, in the 1998 general ledger. This left Duke with a sizable adjustment of $3.8 million to record a true-up in the 1999 general ledger. Historically, prior to 1998, Duke tried to avoid such an overstated accrual.

Based on our investigation, we recommend Duke Power amend its 1998 FERC Form 1 and quarterly filings with the Commissions of North and South Carolina. The "500" and "900" series of "above the line" accounts should be reduced by the $2,744,000 overaccrual that was calculated by Duke in early January 1999, prior to the closing of the books for fiscal 1998.

3. Sales and Use Tax Adjustment

a. According to the August 28, 2001, Duke Report:

During 1998, the State of South Carolina conducted an audit of sales and use tax at Duke Power. The audit resulted in a finding by the State that Duke Power owed a disputed amount related to Use Tax applicable to the operations at the Bad Creek Pumped Storage facility. As a result of the issue, Duke Power's Tax Department determined that as of December 31, 1998, a reserve of approximately $1.7M needed to be recorded for this issue. The entry resulted in a charge to the 500 series of O&M expense accounts to reflect the potential liability. Subsequently, in 1999, the audit was settled for approximately $7.0M with the State. The Duke report concludes that this entry was handled appropriately.

b. Grant Thornton's Findings:

Duke Power underwent a sales and use tax audit by the South Carolina Department of Revenue in 1998. In fiscal 1998, the Company recorded a liability relating to their expected payout for additional amounts owed as a result of this audit. Duke's tax department prepared an analysis of the possible liability relating to this audit, including tax, penalties and interest. In the analysis, some of the amounts related to capital projects, and some of the amounts related to O&M expenses.

The entry to record, for the fiscal year 1998, the estimated liability for the sales and use tax audit was recorded on January 9, 1999 at 4:28 AM. The entry resulted in a $1,706,063 (tax and penalties) reduction of pre-tax utility operating income in 1998 ($2,211,823 O&M expense less Catawba joint owners reimbursement of $505,760). The entries were posted to various 500 series "above the line" accounts on Duke Power's 1998 general ledger. Interest expense associated with this liability was $1,678,000 and was recorded in account 431, a "below the line" account.

The analysis prepared by Duke Power relating to this potential sales tax liability included an estimated penalty of $805,000. This penalty is included in the $2,211,823 shown above. Duke Power did not correctly record the estimated penalties in its 1998 general ledger. If Duke Power were to remove Catawba's portion of the penalty, the amount that still should have been recorded as a penalty would be $620,927. Grant Thornton estimated Catawba's portion to be $184,073. Penalties should be recorded in account 426.3, a "below the line" account.

c. Grant Thornton's Conclusions:

The net result of this entry was to reduce 1998 pre-tax utility operating income by $1.7 million. The penalty portion of this entry should not affect pre-tax utility operating income. Therefore, utility operating income, before taxes, was understated by approximately $621,000 for the penalty portion of the sales and use tax liability.

Based on our investigation, we recommend Duke Power amend its 1998 FERC Form 1 and quarterly filings with the Commissions of North and South Carolina. The amount of expense Duke estimated to be penalties (approximately $620,927) at December 31, 1998 should be removed from the O&M accounts "above the line", and recorded "below the line" in the penalties account 426.3.

4. Payroll Accrual

a. According to the August 28, 2001, Duke Report

This issue involves the cost of employee wages allocable to December 1998, but paid in 1999. At year end 1998, the Duke Power payroll system processed the accounting for bi-weekly paid employees through December 27, 1998. The next payroll processing covered wages related to the period December 28, 1998 through January 10, 1999. Thus the cost of the wages for the last four days of 1998 would not be paid or recorded in the accounting records until January of 1999. This situation resulted in the recording in 1998 of an estimate of the payroll costs incurred and applicable to 1998. The accounting entry made to accomplish this charged $1.8 million to account 920-Administrative and General Salaries and credited account 242-miscellaneous current and accrued liabilities.

b. Grant Thornton's Findings

In December 1998, Duke Power changed its accounting policy to comply with generally accepted accounting principles with respect to payroll obligations. Prior to fiscal 1998, Duke Power did not accrue for biweekly payrolls.

The entry to record this liability was made to the December 1998 ledger on January 8, 1999. The $1.8 million expense was posted to account 920, an "above the line" salaries account. The offsetting credit was posted to a miscellaneous accrued liability account, a balance sheet account. This entry had the effect of decreasing pre-tax utility operating income by $1.8 million for fiscal year 1998.

Duke did not record any accrued payroll for the year ended December 31, 1997. Therefore, payroll expense relating to the last three days of 1997 was recorded in fiscal 1998. Applying the same method of calculating accrued pay for 1998, this would have resulted in approximately $2,300,000 utility payroll accrual being recorded at December 31, 1997 that was expensed entirely in 1998.

c. Grant Thornton's Conclusions:

Generally accepted accounting principles (GAAP) require, when material, the accrual of payroll costs. However, since no such accrual was made at December 31, 1997, Duke's 1998 payroll expense was overstated by $2,300,000. Duke did not inform the State Commissions of this accounting change.

We recommend Duke Power amend its 1998 FERC Form 1 and quarterly filings with the Commissions of North and South Carolina to exclude in fiscal 1998 utility operating expense the beginning of the year 1998 accrual amount of $2,300,000 because it relates to fiscal 1997.

E. Accounting Entries Appropriate Under Applicable Accounting Principles

The following entries which Grant Thornton investigated and based on information supplied by Duke, were appropriate, given applicable accounting principles.

1. Information Management Costs

An adjustment of Information Management (IM) Costs was recorded in December 1998 from Operation and Maintenance (O&M) expense accounts to Administrative and General (A&G) expense accounts. The re-class was made between electric expense accounts to be consistent with treatment in prior years.

IM costs are initially charged to administrative and general 900 series of accounts. In 1998, IM increased emphasis on charging cost centers/departments (i.e. transmission, distribution, hydro, nuclear, etc.) for IT costs incurred on the cost centers' behalf. In 1997, approximately $14 million was identified as charge-back costs to the cost centers. In 1998 approximately $56 million was identified as charge-back, as IM began making a conscious effort to identify all charge back costs.

Of the $56 million identified in 1998 and charged to O&M accounts, it was determined that approximately $14.6 million of the $56 million should have been charged to A&G accounts. The majority of IM costs remained classified as A&G in 1997. In 1998, as a result of the concerted effort to appropriately charge back costs, more departments (cost centers) were incurring O&M costs they believed to be A&G in nature.

As a result, Duke recorded an adjusting entry to reflect the A&G portion of these costs. The entry did not change the total amount charged back to departments or the individual amounts charged to each department. The entry also had no impact on pre-tax utility operating income.

Based on our analysis of the nature and amounts charged and information supplied by Duke Power relating to this reclassification entry, Grant Thornton concurs with Duke Power's conclusion in the August 28, 2001 report filed with the Commissions as to the appropriateness of this entry.

2. Injuries and Damages – General Liability Insurance

In December 1998, Duke made an accrual to increase its reserve for general liabilities damage claims that could arise in the future. The company prepared an analysis of current claims outstanding, claims in process, and an estimate of unasserted claims not yet reported. Based on this analysis, Duke determined an additional reserve was necessary at December 31, 1998.

An adjusting Journal entry was made on January 8, 1999 for $7 million on Duke's fiscal 1998 general ledger. The description of the entry reads, "to record additional auto/gl liability". The entry increased account 925.10, injuries and damages, an "above the line" expense account for $7 million, and increased a reserve account, 228.01, a balance sheet account, for the same $7 million.

Grant Thornton examined payments against this liability and accruals in subsequent years to determine the reasonableness of this estimate. Based on this analysis and information supplied to us by Duke Power, the adjustment of $7,000,000 made for fiscal year 1998 relating to the general liability reserve appears reasonable. As such, we concur with Duke Power's conclusion in the August 28, 2001 report filed with the Commissions as to the appropriateness of this entry.

3. Injuries and Damages – Asbestosis

Duke made payments in 1998 for asbestosis related damages totaling $67,299,568. In December 1998, prior to the accruals to increase its reserve, the amount of the reserve was approximately $33 million. Duke Power made an additional accrual on January 10, 1999, to increase its reserve account 228.01, accrued injuries and damages-electric (a balance sheet account), and also increase account 925, injuries and damages, an "above the line" expense account. The amount of the entry was $20 million. This entry decreased pre-tax utility operating income by $20 million.

After that initial $20 million entry was posted, a second entry was posted on January 13, 1999. This second entry was made to increase the reserve account 228.01 and the "above the line" expense account 925, by an additional $5 million. This $5 million entry was recorded after the books were closed for Duke Power in 1998, and therefore does not appear in any of the electronic general ledger activity provided to Grant Thornton. It was recorded on the general ledger in Fiscal 1999, as an adjustment to opening balances.

These entries reduced pre-tax utility operating income by $25,000,000 for the year ended December 31, 1998. Duke Power made payments for asbestosis damages totaling $95,000,000 in February and May 1999, and applied them against account 228.01. They also incrementally accrued an additional $100,000,000 reserve to account 228.01 in March 1999, June 1999 and September 1999 for additional estimated asbestosis damages. Account 925 – injuries and damages (above the line expense account), was also increased by this $100,000,000 accrual.

Based on our analysis of payments applied against the liability and accruals made in subsequent years and information supplied by Duke, the adjustment of $25,000,000 made for fiscal year ended 1998 relating to the asbestosis liability reserve appears reasonable. As such, we concur with Duke Power's conclusion in the August 28, 2001 report filed with the Commissions as to the appropriateness of this entry.

4. **DE&S Facility Costs**

Duke Energy Corporation allocates/charges each Duke affiliate their share of facility costs, corporate governance, shared services, and information management costs. Duke Power's share of those type costs expensed "above the line" for 1998 were approximately $1.1 million.

Based on our review and understanding of the reimbursable costs and scope of services description in Duke's Technical Service Agreement with Duke Engineering, and our review of the method of calculating the overhead charged by DE&S to Duke Power and information supplied by Duke, we concur with Duke Power's conclusion in the August 28, 2001 report filed with the Commissions as to the reasonableness of the allocation of the DE&S facility costs.

5. **United Telephone Write-off**

Duke Power had receivables from United Telephone on its books dating back to 1992 relating to pole attachment billings for the shared use of utility poles owned by Duke Power. In October 1998, the South Carolina Court of Appeals ruled against Duke Power for the collection of these receivables. Duke Power did not have a reserve for bad debt specifically established against these receivables.

Duke recorded revenue relating to these disputed billings in the amount of $340,410 for the month of December 1998 in account 454.20 – Pole & Line Attachments (Rent from electric property sub-account), an "above the line" revenue account. Duke then wrote-off the December 1998 revenue net of an expected payment $32,067 (the same amount as received for 1997 billings), along with the remaining unpaid portion of United Telephone billings for these pole attachments from all previous years to account 904, uncollectible accounts. The entry to write-off these receivables was made on January 8, 1999, and resulted in a debit to account 454.20 for $308,343 and a debit to account 904 for $1,637,628, with the offsetting credits posted to account 143, a balance sheet receivable account.

The net impact of this entry was to increase above the line O&M expenses by $1,637,628, and decrease rent from electric property by $308,343, for a combined reduction of pre-tax utility operating income of $1,945,971. Based on our review of the supporting documentation for the receivable write-off, we concur with Duke Power's conclusion in the August 28, 2001 report filed with the Commissions as to the appropriateness of this entry.

6. Oxford Fire

A fire occurred at the Duke Power Oxford Hydro Station (dam) on January 12, 1998. Duke Power incurred costs for the repair and maintenance of this facility. The costs were split approximately 53%/47% between capital additions and O&M structure maintenance expenses, respectively. In December of 1998, management made an estimate of costs that were going to be reimbursed through insurance policies. This estimate was recorded as a reduction of costs incurred. The net reduction of operating expenses was approximately $775,000.

This entry was recorded on January 8, 1999 in the fiscal 1998 general ledger. The entry resulted in a credit (reduction) to account 542, an "above the line" maintenance account, of $775,000. In December 1999, insurance proceeds were received and a proportionate amount of the insurance proceeds were allocated to capital and expense accounts based on their respective percentages to total actual costs.

We concur with Duke Power's conclusion in the August 28, 2001 report filed with the Commissions relating to this matter.

7. December Ice Storm

In the winter of 1998 (Christmas Eve) an ice storm occurred in the Carolinas. An accrual was made to provide for costs associated with restoring service to customers, such as overtime pay, contract labor, materials and supplies, that were incurred in 1998. The accrual was later reversed in the fiscal year 1999 general ledger and actual expenses were recorded.

The accrual was made in the amount of $2,720,305 and posted to the 1998 general ledger on January 6, 1999. The portion of the accrual that was recorded "above the line" in account 593, maintenance of overhead lines, was $2,420,305. This accrual included an estimate for labor incurred, supplies and contract labor. This had an effect of decreasing pre-tax utility operating income reported to the Commissions for 1998 by $2,420,305.

In January and February 1999, Duke Power reversed this estimate by reducing account 593 for $2,420,305. Actual expenses incurred were then recorded as paid in 1999.

Grant Thornton analyzed the actual expenses associated with this ice storm.

We concur with Duke Power's conclusion in the August 28, 2001 report filed with the Commissions relating to this 1998 accrual.

VI. Recap

Primarily in response to the SCANA decision, Duke Power undertook a coordinated effort to identify and record adjusting and/or reclassification entries which would lower Duke's net utility operating income reported to the State Commissions.

One Duke manager is on record as targeting $70 million of "additional expense" as being needed " . . .to avoid reporting over-earnings to regulators". Grant Thornton's investigation has identified approximately $64.4 million of 1998 year-end entries made by Duke which were, in Grant Thornton's opinion, inconsistent with applicable accounting principles, inconsistent with Duke Power's past practices or without proper justification. Further, Grant Thornton's investigation identified approximately $24.0 million in 1999 and $35.2 million in 2000 of entries which are inconsistent with applicable accounting principles, industry practice and Duke Power's past practices.

/s/ GRANT THORNTON LLP